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IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF UNS GAS, INC. DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA CORPORATION COMMISSIONON.	DOCKET NO. G-04204A-06-0463
IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. TO REVIEW AND REVISE ITS PURCHASED GAS ADJUSTOR.	DOCKET NO. G-04204A-06-0013
IN THE MATTER OF THE INQUIRY INTO THE PRUDENCE OF THE GAS PROCUREMENT PRACTICES OF UNS GAS, INC.	DOCKET NO. G-04204A-05-0831

STAFF'S EXCEPTIONS

I. Introduction

Staff files the following very limited exceptions to Assistant Chief Administrative Law Judge Node's Recommended Opinion and Order ("ROO") in this case. Staff would like to start by complimenting Judge Nodes on what Staff finds to be a well-reasoned and well-balanced ROO in this case. With the few minor exceptions noted below, Staff urges the Commission to adopt the ROO in its entirety.

II. Discussion

A. <u>Legal Expenses Related to the El Paso FERC Rate Case.</u>

At page 20 of the ROO, the Company is allowed $400,000.00 per year for legal expenses related to the El Paso FERC rate case. Staff agrees with Judge Nodes that the $400,000.00 appears to be supported by information in the record based upon UNSG's actuals for the years 2004, 2005 and 2006, and UNSG's projections for 2007. Staff would caution against relying heavily upon UNSG's 2006 level of costs, which was not presented in rebuttal and was not audited. Because the El Paso case was settled late in 2006, it is likely that the $425,540 amount listed by UNSG witness Dukes in his rebuttal also includes substantial legal cost related to that FERC proceeding. The 2005 test year amount of $488,380.00 was reviewed in detail by Staff (and by RUCO) and both parties identified $311,000.00 of that test year amount to be related to settlement discussions for the El Paso Natural Gas rate case at FERC.[1] Staff viewed the $311,000.00 as a non-recurring expense since the El Paso case settled near the end of 2006, and therefore removed this amount, leaving an allowance of $177,329 for legal expense in the test year.

Staff is also concerned that the proposed decision at page 20, line 13 ("its projected legal expenses for 2007 are $425,208, citing Ex. A-14 at 9) appears to have given equal weight to the unaudited, annualized information on UNSG legal expense based on partial year 2007 information (only two of 12 months) that was even heavily caveated when it was presented for the first time by UNSG witness Dukes in his rejoinder testimony. Page 9, lines 6-10, of Mr. Dukes' rejoinder states as follows concerning this:

> The Company provided the legal expenses for 2006 of $425,541 as support for the two-year average4. It also provided information that the Company had incurred $70,868 in legal expense at the end of February 2007; which would annualize to $425,208. I recognize that annualizing two months of data for 2007 is not necessarily a reliable indicator, but it is indicative of the Company's position that recurring legal expenses will be in the $400,00 range for the foreseeable future.

Staff submits that it was inappropriate to have placed any weight on a two-months annualized figure for estimated 2007 which was presented for the first time in UNSG's rejoinder testimony, and which was even explicitly recognized by the presenting witness to be "not necessarily a reliable indicator." From the discussion on page 20 of the proposed decision, unfortunately it appears that the ALJ gave equal weight to this highly questionable annualization that was attempted by Mr. Dukes of only two months information into a 2007 full year amount, as support for allowing UNSG $400,000 per year as a normal level of legal expense. Staff submits that placing any weight, much less equal weight, on

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[1] See Ex. S-23 (Smith Direct), p. 30.

the two months annualization of estimated 2007 presented by UNSG in its rejoinder testimony is definitely not a reliable indicator by any means, and reliance on such information in setting the ALJ's recommended $400,000 annual allowance constitutes an error.

Staff agrees with the Company (Dukes rebuttal page 17) that "The Company always incurs legal expenses each year as a part of doing business. The objective should be to set legal expenses at a just and reasonable level that is reflective of how much is likely to be incurred annually. So, customers do not pay more than they should and the shareholders recover their cost."

Staff does not view the 2005 amount of $488,380 or the 2006 amount of $425,540 as being representative of normal, ongoing levels of legal expense for UNSG because in both these years UNSG spent heavily on legal expense for the El Paso rate case before FERC. As noted above, for the 2005 test year alone, approximately $311,000 of the $488,380 total was for the El Paso FERC case, which settled. Staff is therefore concerned that using the abnormally high years of 2005 and 2006 as the basis for determining a "normal" amount would almost assuredly produce an amount that is too high. Again, the objective is not to give UNSG a blank check for legal expense, but is to set legal expenses at a just and reasonable level that is reflective of how much is likely to be incurred annually.

Staff has also been participating in the El Paso rate case at FERC and recognizes that under the recently approved rate case settlement agreement, El Paso will be filing its next rate case at FERC at the end of June 2008, which is eight months from now. Staff also recognizes that the settlement agreement approved by FERC for the El Paso case has resulted in deferring a number of significant issues to this upcoming El Paso rate case. Staff thus recognizes that UNSG will likely incur additional expense for participating in the next El Paso rate case before FERC, which is currently scheduled to be filed in June 2008. However, this recognition must be tempered against the reality that El Paso FERC cases have not been annually occurring events. Thus, Staff believes that the Company's legal expense must be adjusted to a normal, ongoing level. The allowance should therefore recognize that UNSG does not need to incur large amounts of legal expenses for El Paso pipeline cases before FERC annually.

. . .

After reviewing the proposed decision and the recent developments in the El Paso case, and the current anticipation that El Paso will file its next rate case at FERC in June 2008, which case will include significant issues deferred into that case from the last El Paso case, Staff now recognizes that a normal amount less than the $400,000 per year recommended by the ALJ but higher than the $177,329 amount remaining in the 2005 test year after Staff's recommended adjustment would better provide for a normal level of recurring legal expense. In determining the appropriate normalized level for such legal expenses, Staff also believes it is important to recognize that such expenses are, to at least some extent, discretionary with Company management.

The rate case expense for UNSG in the current case is being normalized over a three-year period. Staff believes that a total allowance of $1 million for UNSG's legal expense, normalized over three years, would be more than sufficient to provide for normal annually recurring and appropriate legal expense. This would provide for an annual allowance of $333,400 per year. The $333,400 annual allowance recognizes that UNSG's 2005 and 2006 legal expenses were abnormally high due to the expense related to El Paso FERC proceeding that was settled late in 2006. Staff would also place no reliance upon the unreliable 2007 annualized amount, which was based on only two months, and which UNSG submitted for the first time in its rejoinder testimony.

For the reasons described above, Staff recommends that the $400,000 allowance for annually recurring, normal legal expense contained in the proposed decision inappropriately relied upon a highly questionable annualized estimate for 2007, as well as 2005 and 2006 legal expenses that contained substantial nonrecurring amounts and were thus abnormally high. Staff therefore recommends that the $400,000 allowance in the proposed decision be revised downward to $333,400 in order to recognize that UNSG has incurred and would be likely to incur some significant but not annually recurring legal expense related to UNSG's participation in pipeline cases before FERC, as well as other recurring legal expense.

B. <u>American Gas Association ("AGA") Dues.</u>

At page 20 of the ROO, only $1,523.00 of AGA dues was removed based on RUCO's recommendation, which the Company accepted. This removed only 1.54% for marketing and 2.10% for lobbying. In contrast, Staff recommended the removal of 40% of AGA dues based on two

NARUC sponsored audits of AGA expenditures and a decision by the Florida Public Service Commission which disallowed 40% of AGA dues. Specifically, Staff proposed to reduce test year expense by $26,868.00.[2] As already indicated this adjustment removed 40 % of UNS Gas' 2005 AGA dues which totaled $41,854.00.

The ALJ stated that "we expect UNS in its next rate case to provide more detailed support for allowance of AGA dues and how the AGA's activities benefit the Company's customers aside from marketing and lobbying efforts." Staff supports this recommendation but believes that it should be adopted in addition to Staff's recommended 40% AGA dues disallowance, not in place of Staff's recommended disallowance.

Staff Witness Ralph Smith testified that as a result of the Southwest Gas decision the Company was already on notice of the informational expected by the Commission in the future with respect to association dues:

> I also note the clear directive from the Commission at page 14 of that order [Decision 68487] that: 'in its next rate case filing the Company should provide a clearer picture of AGA functions and how the AGA's activities provide specific benefits to the Company and its Arizona ratepayers.[3]

While that directive in Decision 68487 applied to Southwest Gas, Staff believes that it should have effectively put other gas distribution companies in the State which have AGA memberships on notice concerning the type of information the Commission would expect them to produce in a rate case in order to justify the inclusion of AGA dues in rates. It is clear from UNSG's direct, rebuttal and rejoinder testimony that UNSG was aware of the Commission's Decision 68487 in the Southwest Gas case.

In the current case, even though asked, UNS Gas did not produced such information. Staff issued UNS Gas discovery to obtain such information, and UNS Gas simply did not provide it. As illustrative examples, the Company's response to STF 5.62(c) stated: "The Company did not receive any materials from the AGA specifying what percentage of their expenses is dedicated to lobbying or advocacy activities. UNS Gas has not excluded any portion of dues paid to the AGA during the test

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[2] See Ex. S-23, Schedule C-14.

year." Similarly, the Company's response to STF 5.62(b) stated: "UNS Gas does not maintain any descriptive material regarding the financial statements, annual budgets or activities of the AGA."

Consequently, Staff does not believe that the Company has not met its burden of proof for including AGA dues in rates.

C. Warm Spirits Program

As the ROO notes, Warm Spirits is a program, funded by customer contributions, that provides emergency bill payment assistance to low-income customers.[4] Staff would recommend that the following clarification be added to the discussion of this program at line 8.

> The Company originally proposed that the Low-Income Weatherization Program include $21,600 in emergency bill assistance, separately and in addition to that already available through Warm Spirits. The $21,600 would have been part of the UNS Gas DSM portfolio and funded through the DSM adjustor. Staff objected because emergency bill assistance is not DSM and should not be funded as DSM. Staff proposed, and the company agreed, that the $21,600 be moved into Warm Spirits and funded through base rates. We agree that the $21,600 in additional emergency bill assistance should not be funded through the DSM adjustor and that this amount should be moved into Warm Spirits and funded through base rates.

D. Hypothetical Capital Structure.

The Administrative Law Judge adopted UNS Gas' request for a hypothetical capital structure comprised of 50% equity and 50% debt.[5]

Staff Witness Parcell proposed to use the actual capital structure of UNS Gas, which was 55.33% long-term debt and 44.67% common equity. The actual capital structure of UNS Gas exceeds that of UniSource and Tucson Electric Power.

The actual capital structure of UNS Gas is very similar to that of publicly-traded electric and combination gas-electric holding companies. This is important since the cost of equity for UNS Gas was established using proxy companies with equity ratios below 50% on average – thus there is a mis-match between ROE and capital structure if a hypothetical capital structure is used with Staff's ROE recommendation. Stated differently, the financial risk of the proxy group would be less than that of UNS Gas if a 50% hypothetical capital structure were to be used.

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[4] ROO at p. 66.

[5] ROO at p. 38.

Use of a hypothetical capital structure for UNS Gas has the effect of increasing the Company's implicit cost of equity by 50 basis points.

In addition, UNS Electric did not request a hypothetical capital structure and instead used an actual capital structure in their recent rate filing which is pending before the Commission.

III. Conclusion

Staff supports the ROO that was issued on October 15, 2007, with the exception of the limited issues discussed above.

RESPECTFULLY SUBMITTED this 24th day of October, 2007.

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